

QUARTERLY REPORT



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

February 6, 2003

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended September 30, 2002. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

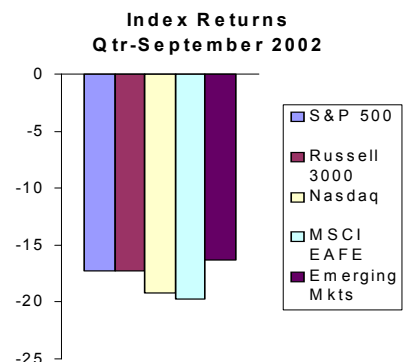
History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 5,989 active members and 4,115 retirees participating in the System as of June 30, 2002.

Capital Markets and Economic Conditions

The impact the equity bear market has had on household wealth levels is significant. The Federal Reserve figures on household net worth through June indicate that the average householder's net worth relative to disposable personal income is now back to the levels of the 1960s despite the ongoing support from high housing prices. After the market drop of the September quarter, the average householder's net worth is now more than 25% below its peak level. This continued erosion of wealth will have a major effect on consumer confidence and spending.

During the quarter, investors set records by moving \$51 billion from equity funds and \$43 billion into bond funds. Most of the equity fund outflows came from large-cap domestic growth and value funds. The inflows went into government bond funds that invest in mortgage-backed securities and corporate bond funds rated A or better. Analysts attribute the movement of funds to poor economic news, continued revelations of corporate malfeasance and the looming prospect of war in Iraq.

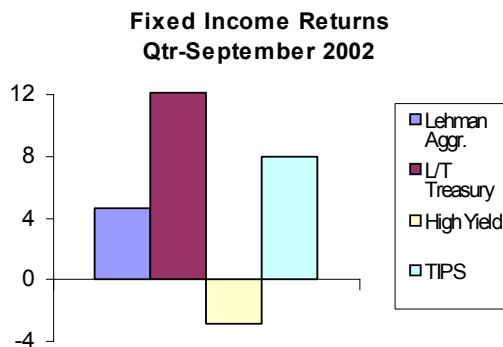


The late August market sell-off continued into September as the economic outlook continued to weaken. Similar to August, the macro economic news was mixed with retail sales and consumer spending numbers coming in better than expected, but consumer confidence, new unemployment claims and inventories looked worse than expected. The U.S. equity market had its worst quarter since 1987. The Dow Jones Industrial Average and the S&P 500 each fell 18%, with the small cap indices falling over 20%.

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Over 90% of the companies in the S&P 500 fell and all industries had negative returns with the worst performing sectors being the technology and telecommunications groups. Our combined domestic equity performance was a loss of 16.44% compared to our benchmark Russell 3000 Index that was down 17.23%. On the international front, European stocks fell more than stocks in the U.S. or Japan. Germany recorded the worst performance among the developed markets. The woes of Germany, with its contracting manufacturing sector and persistent unemployment, appeared to be affecting the economies and fiscal health of other large European countries. Our combined international equity performance was a loss of 18.47% compared to the 19.3% loss of the benchmark index.

Bad news for stocks was good news for bonds (see chart at right). U.S. Treasury securities benefited from their safe-haven status and turned in the best results by far with a quarter return of 12.07%, followed by agencies and corporates rated A or better. The yield on the 10-year Treasury bond dropped to 3.6% by quarter end, the lowest in over 40 years. Mortgage-backed securities lagged considerably as prepayments soared. High-yield bonds had negative results as credit rating agencies continued to be aggressive in downgrading the debt of financially strapped companies, especially in the energy and telecom areas. Our combined fixed income managers outperformed the benchmark index by over 100 bpts.



For the quarter ending September, the return for the total fund was a loss of 9.49% compared to the 10.51% loss of the System's benchmark. For the one-year period ended September 30, our return was a loss of 6.98% compared to the benchmark loss of 9.35%, outperforming the benchmark by over 230 basis points.

Additions

The primary sources of additions for the System include member and County contributions and investment income. The following tables show the source and amount of additions for the quarter ending September 30, 2002.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr Ended 9/30/02	Fiscal YTD
Employer Contributions	\$ 13.4	\$ 13.4
Member Contributions	3.7	3.7
Net Investment Loss	(159.4)	(159.4)
	\$ (142.3)	\$ (142.3)

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

Employees' Retirement System Deductions by Type (millions)

	<u>QTR ended 9/30/02</u>	<u>Fiscal YTD</u>
Benefits	\$24.0	\$24.0
Refunds	0.2	0.2
Administrative Expenses	<u>0.4</u>	<u>0.4</u>
	\$24.6	\$24.6

Outlook

Overcapacity still exists in most areas and the markets will probably remain slow to adjust to the reality of lower earnings. Real GDP growth appears to have accelerated to a 4% growth rate in the third quarter but looks set to slow considerably in the December quarter. This up/down pattern seems to reflect the normal choppiness of consumer spending rather than a more sustained growth downshift. Importantly, the fuel for a reacceleration of growth into early 2003 is visible. Business responded to the summer sell-off in the stock market and credit markets by putting a freeze on spending and hiring, and the forecast for company growth has been lowered accordingly. Economic performance will continue to be sensitive to financial market swings, as well as the prospects for possible military action in Iraq. The Federal Reserve Board might consider further monetary easing in light of continuous weakness.

Major Initiatives

During the last quarter, the Board approved the rebalancing of System assets back to target range by transferring \$30 million in assets from fixed income to equities. The Board approved an Alternative Investment Policy outlining guidelines and benchmarks for investments within the asset class. In addition, the Board hired Adams Street as a private equity fund-of-funds manager. Within the international sector, the Board hired Marathon, an equity manager based in London, to replace Lazard.

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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS September 30, 2002

Assets

Equity in County's pooled cash and investments	<u>\$462,156</u>
Investments	
Northern Trust	1,721,360,591
Aetna	7,789,614
Fidelity - Elected Officials Plan	494,286
Fidelity - Deferred Retirement Option Plan	<u>3,701,278</u>
Total investments	<u>1,733,345,769</u>
Contributions receivable	4,315,835
Fixed assets, at cost:	
Office equipment	111,375
Less: accumulated depreciation	<u>111,375</u>
Net fixed assets	<u>-</u>
Total assets	<u>1,738,123,760</u>

Liabilities

Benefits payable and other liabilities	<u>227,521,696</u>
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Net assets held in trust for pension benefits	<u>\$1,510,602,064</u>
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EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF CHANGES IN PLAN NET ASSETS September 30, 2002

Additions	Quarter	Fiscal YTD
Contributions		
Employer	\$13,445,332	\$13,445,332
Members	<u>3,710,462</u>	<u>3,710,462</u>
Total contributions	<u>17,155,794</u>	<u>17,155,794</u>
Investment Income (loss)	(158,020,785)	(158,020,785)
Less investment expenses	<u>1,410,173</u>	<u>1,410,173</u>
Net investment income	<u>(159,430,958)</u>	<u>(159,430,958)</u>
Total additions	<u>(142,275,164)</u>	<u>(142,275,164)</u>
Deductions		
Retiree benefits	18,256,387	18,256,387
Disability benefits	4,565,000	4,565,000
Survivor benefits	1,157,000	1,157,000
Refunds	198,602	198,602
Administrative expenses	<u>465,901</u>	<u>465,901</u>
Total deductions	<u>24,642,890</u>	<u>24,642,890</u>
Net increase (decrease)	<u>(166,918,054)</u>	<u>(166,918,054)</u>
Net assets held in trust for pension benefits		
Beginning of period	<u>1,677,520,118</u>	<u>1,677,520,118</u>
End of period	<u>\$1,510,602,064</u>	<u>\$1,510,602,064</u>